Abstract

Ronald Coase’s work presents a continuing challenge to the established neoclassical paradigm. His incorporation of transactions cost into economic theory enables many questions of organisational structure to be addressed but also implies a world of continuing evolutionary change rather than static equilibrium. This paper reviews some of Coase’s most influential papers and considers their implications for the future of public policy and economic theory.

Key words: Transactions cost; Firms; Contracts; Exchange; Property Rights

JEL Codes: B31, B52, D23,

1. Introduction

Even amongst Nobel laureates it is rare to find people who have not only produced great work in a particular field but have profoundly influenced the way that their fellow scientists think about their subject. It would be hard to maintain that Ronald Coase produced what Kuhn (1962) might have characterised a ‘paradigm shift’ in Economics, but his work forced Economists to look at things from a different, and initially unfamiliar, perspective. Coase’s work does not seem to have been received as ‘normal science’ (to use Kuhn’s terminology) even if it did not quite measure up to ‘revolutionary science’ and result in the overthrow of the established neoclassical norm. It sits somewhere in between these categories, subtly subverting established thinking rather than sweeping it aside.

Coase was not in the business of adding accretions of support to the established neoclassical paradigm but of asking questions that this paradigm seemed to struggle to answer. In some ways he could be categorised as promoting a ‘counter-revolutionary’ paradigm shift – a re-discovery of an earlier paradigm that had been itself eroded. This view of the subject had the social activity of voluntary exchange and the gains to trade at its heart. Indeed from Adam Smith to Alfred Marshall, while many technical aspects of the evolving subject of Economics changed a great deal, the view that its subject matter concerned people ‘in the everyday business of life’ (Marshall) or trying to ‘better their condition’ through using the ‘natural’ propensity to ‘truck, barter and exchange’ (Smith) would have seemed, in itself, rather uncontroversial. It is a curious feature of the way Economics developed in the early and mid-twentieth century that it became, instead, the study of rational choice subject to known constraints – including known prices of goods and factor inputs.

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The context of individual choice was thus altered. Instead of facing the ‘social’ problem of exchange that arises when people have to decide with whom to trade and on what terms, the problem was changed to the decision concerning how much of a good or service to supply or demand to an anonymous ‘market’ at the prevailing ‘market clearing’ price. The process of exchange and the down to earth business problems that accompany it were, so to speak, purged from the subject matter of Economics. The market institutions that facilitated exchange were assumed to be so refined and advanced that the prices formed within them were all that was required for individual transactors to make rational decisions about the use of their own resources. Economists did not study ‘exchange’ so much as ‘the price system’ and, in particular, the perfectly competitive price system, a framework that was capable, in spite of formal theorems concerning its efficiency, of almost entirely obscuring the actual activity of trade. It was as if every exchange were mediated in a giant auction house of vast sophistication where all deals were concluded at ‘arm’s length’ and no buyer ever had to look a seller in the eye.

For Coase economics was about capturing gains to trade through voluntary agreement. In the following sections this world view is illustrated by outlining the arguments contained in several of his most famous papers. Section 2 considers the pivotal role of the concept of ‘transactions cost’ in Coase’s work, while sections 3 and 4 discuss his influence on public policy and on economic theory respectively.

2. Transactions Cost

The conceptual innovation at the root of Coase’s approach to exchange was the idea of ‘transactions cost’. Economists might all accept that ‘there’s no such thing as a free lunch’ and lecture their students about ‘opportunity cost’ but it took Coase’s insight to point out that there was a free lunch at the heart of neoclassical perfectly competitive price theory. The process of contracting was costless. The ‘cost’ of a certain output was universally understood as the alternative output foregone – but these achievable alternatives tended to be conceived as technologically determined. In fact the available alternatives for Coase were not determined only by technology but by the alternative contractual settings that might be implemented. Even with a given technology available, different results could be anticipated from different organisational and institutional structures embodying differing incentives for the participants. Economics was not a branch of engineering but a study of the social arrangements that permitted individuals to cooperate to their mutual advantage and to secure the greatest possible gains to trade. It was not a matter of indifference how people organised themselves and the cost of adopting one form of organisation was another foregone – there were costs associated with choice of contractual arrangements.

Transactions cost thus proved to be the key concept that opened up whole new areas of study and reintroduced economists to areas that they had tended to vacate as the subject became more specialised in the first half of the twentieth century. The theory of the firm was transformed in the 1960s and 1970s as questions of scope, governance, ownership and contractual relations were once more addressed as significant issues (Williamson (1979, 1985). But even wider considerations were naturally suggested as institutions such as
property rights and the law of contract and tort became viewed as crucial to the determination of the cost of transacting. This led to the development of ‘Legal Economics’ and the study of the economic efficiency of legal rules and practices as an important sub-discipline (Posner 1973). The collapse of central planning in the late 1980s and thereafter also revealed the importance of supporting institutions to the functioning of market economies and indirectly provided a further boost to the study of Coase’s work. The New Institutional Economics has taken ideas from many sources but it is Coasian in its essential concern – the analysis of those institutions that underpin the ability of individuals to enter into mutually advantageous agreements.

2.1 *Transactions Cost: The Firm*

It was in the context of his study of the structure of industry that Coase first drew attention to the central importance of transactions cost to economics. He visited the United States in 1931 on a Cassel travelling scholarship to investigate differences in the organisation of industries. It was recognised that the degree of vertical integration differed between countries and across industries and that some firms were more diversified than others – producing a range of different products rather than focussing on a single market – but the reasons for this organisational variety were not well established. John Jewkes, for example, had similarly visited the United States as a Rockefeller Foundation Fellow in 1929 and published a study on the efficiency of American industry (1930) in which various differences between firms in the United Kingdom and the United States were considered. Spinning and weaving in the cotton industry, for example, were more integrated in the United States compared with the United Kingdom where firms remained smaller, more specialised and located in distinct areas. These differences could be investigated and explained by looking at available technical possibilities, differing home market demands and (in an era of trade restrictions) differing sources of supply of inputs and export markets. It was Coase (1937), however, who attacked the problem by going back to the very definition of ‘the firm’ itself and its ‘raison d’être’.

For Coase, ‘the market’ and ‘the firm’ are simply alternative ways of co-ordinating production. In the world of market exchange ‘price movements direct production’ and people adjust their behaviour in response to these signals. ‘Within the firm, these market transactions are eliminated’ and in their place ‘is substituted the entrepreneur-co-ordinator, who directs production’. Thus ‘the distinguishing mark of the firm is the supersession of the price mechanism’. Within the firm people agree to be directed and fit into a process of conscious planning. They agree to do what they are asked to do (within limits determined by employment contracts). But why is this suppression of ‘market’ contracting advantageous? Coase argues that it must be because ‘there is a cost of using the price mechanism’ - what is now called ‘transactions cost’. The firm economises on transactions cost by substituting a simple, durable, loosely specified ‘employment’ contract with an entrepreneur co-ordinator in place of a series of more highly specified and possibly multi-lateral contracts requiring continuous negotiation and re-negotiation in the face of endlessly changing circumstances.
Having proposed to explain the firm by reference to its ability to economise on the costs of transacting in markets the natural question arises ‘why are there any market transactions at all? Why is not all production carried on in one big firm?’ Here Coase simply proposes that there are organisation costs within firms that will tend to rise as the number of transactions to be internally co-ordinated by conscious design increases. There are ‘diminishing returns to management’ as the co-ordinator wrestles with rising complexity and as the possibility of mistaken decisions and waste of resources increases. A simple theory of the size and scope of the firm emerges from this conceptual set-up. Transactions will be organised within a firm by conscious planning until the cost of further internal organisation becomes equal to the cost of using the market and transacting outside the firm. The cost of organising the marginal transaction will be the same whether it is conducted within the firm or across the market.

This conclusion serves both to illustrate the conservative nature of Coase’s contribution as well as its great capacity to undermine established doctrine and suggest new areas of application. On the one hand, the idea that the marginal cost of an activity usually eventually rises and that there are always different ways of achieving a particular goal could not be more conventional. Minimising the total cost of achieving an objective will imply equalising the marginal costs associated with the various ways of pursuing it. If it is possible to increase output by using more labour or more capital and these two factors are substitutes, minimising the total cost of output will imply making sure that the cost of using more capital for the marginal unit of output is precisely the same as the cost of using more labour. All Coase is doing is looking at two substitute methods of handling the marginal transaction rather than two substitutable inputs as methods of producing the marginal unit of output.

On the other hand, by diverting attention from the output of the firm to the transactions arranged within it Coase highlights its social rather than technological nature. Even in modern textbooks on Microeconomics the theory of the firm and its associated ‘cost curves’ are founded on the ‘production function’ – the physical relationship between ‘output’ and ‘input’ – determined by the available technology. Coase is looking at the problem contractually, not technologically, thus potentially undermining the traditional neoclassical theory of supply. The latter, however, is a theory of the output of the (usually single product) firm and the industry, whereas Coase’s analysis is a theory of organisation – which was, after all, what he went to the United States to study. Recognition of transactions costs means, according to Coase, that ‘the whole of the “structure of competitive industry” becomes tractable by the ordinary technique of economic analysis’.

2.2 Transactions Cost: Externalities

Coase’s trademark interest in the actual situation confronting potential contractors and the alternative possible institutional alternatives available to them is also revealed in his work on social cost. The conventional approach to the existence of harm experienced by third parties, deriving from the work of A.C. Pigou (1920), confined itself to pointing out that market prices might not reflect the full ‘social cost’ of the ‘harmful’ activity. In the face of such ‘market failure’, a suitable policy response would be to introduce taxes on the offending activity to reflect the external damage caused. Those deciding on how much of the activity to
undertake would face its full marginal social cost and would therefore only go ahead if they were prepared to pay enough potentially to compensate all the inputs and all those external parties who might be adversely affected. Coase’s objection to this reasoning was not that taxes could never be justified but that the simple existence of external harm could not do so in itself. A much fuller institutional analysis was necessary, and in particular an attention to the prevailing legal rules and the possible ways that people might come to mutually advantageous agreements.

The essential difference between Coasian and Pigouvian traditions is the point of departure. Pigou’s attention is fixed on the relatively impersonal ‘price system’ and the ideal that the prices at which goods and factors are traded should reflect their marginal social costs. Coase’s attention is on exchange and the ideal that reducing the impediments to agreement will permit further gains to trade. In ‘The Problem of Social Cost’ (1960) Coase considers various classic legal cases from mid and late nineteenth century England in which noises from a confectioner’s grinding machinery interfere with a neighbouring doctor’s consulting room; fumes from a manufacturer of sulphate of ammonia interfere with a weaver of coconut matting; the construction of a wall causes a neighbour’s domestic fire to emit smoke into his living room; sparks from a steam railway set fire to neighbouring woodland and so forth.

Coase makes the point that although there might be a tendency to think of one party (usually the emitter of noise or fumes) ‘harming’ another, the ‘harm’ is actually entirely reciprocal. Sparks from a steam engine would appear to harm the farmer if the railway is not liable for crop losses, but equally the presence near the track of the farmer’s tinder dry crops would seem to harm the railway if the railway does have to pay compensation.

Coase shows that however the property rights are assigned – whether, for example, the railway company has the right to emit sparks with impunity or the adjacent farmers have a right not to be inconvenienced by the incursion of hot embers onto their land – a negotiated deal should enable potential social gains to be captured. Suppose that the agricultural losses associated with running trains over a certain stretch of track are greater than the cost of installing some technical spark-suppressing innovation. A train operator facing civil action and a possible injunction or the award of damages would clearly offer to introduce the innovation – assuming that this additional cost did not render the railway uneconomic and lead to its closure. Conversely, if the railway had the right to emit sparks, the farmers would have an incentive to bribe the train operator to install the spark suppressing equipment since the value of the crops thereby protected (and hence the maximum bribe) would exceed the minimum sum that the rail company would require. Of course, installing special equipment might not be the only (or the cheapest) way of solving the problem. Perhaps the cheapest and simplest solution would be to avoid planting crops within a certain distance of the line. A railway company might simply offer the farmers incentives to cut back their cultivated area by offering them the net income that otherwise they would derive. Again, if farmers’ property rights did not give them protection, their own interests would nevertheless lead them to cut back the cultivated area to margins that remained profitable. They would do this rather than adopt the more expensive option of bribing the train company to install special equipment.
It seemed, therefore, that providing the costs of negotiating and enforcing agreements could be ignored (there were no transactions costs) the precise assignment of property rights did not influence the final allocation of resources – a proposition that became known as ‘the Coase Theorem’. Train operators would no doubt prefer to be able to emit sparks and farmers would prefer to be protected from sparks. Income distribution would be different depending upon the legal rules in operation. But, either way, if there were net social benefits to running trains they would run, and if there were net social benefits to installing spark inhibitors they would be installed. Coase was, of course, only too aware that transactions costs are not zero and that where they are substantial they might potentially stand in the way of beneficial agreements. It would then no longer be possible to argue that the assignment of property rights would not matter to the final outcome. In section VI of his (1960) paper he considers the consequences of high transactions cost. Perhaps a firm (and the substitution of internal organisation for the market) would be beneficial. Here we might envisage the train company merging with the farmer to form a transport and agricultural conglomerate. Alternatively the government could regulate the activities of companies and enforce suitable outcomes acting as a kind of ‘super-firm’ (p.17). In either case, the cost of collecting information and establishing an administrative apparatus with suitable incentives cannot be ignored and one should not overlook the possibility that there is ‘a further alternative, which is to do nothing about the problem at all’. What is required is ‘patient study of how, in practice, the market, firms and governments handle the problem of harmful effects’ (p.18).

3. The Policy Legacy

3.1 Regulation

Much of the argument that appeared in ‘The Problem of Social Cost’ was actually rehearsed in Coase (1959), a slightly earlier paper on the more specific question of the regulation of broadcasting and the activities of the Federal Communications Commission. Here Coase describes the grant of licenses to broadcasters to use particular frequencies. The licensing system was established and defended on the grounds that an alternative ‘free for all’ would be chaotic and that interference between the signals of those broadcasting on the same or adjacent frequencies would cause great inconvenience. Coase pointed out that the alternative to regulation was not a ‘free for all’ in the use of the spectrum, any more than the alternative to the government assignment of land was a ‘free for all’ in the use of land. The question was whether it would be better to assign licenses by administrative processes or whether they should be seen as conferring property rights that could be auctioned and thus allocated to those willing to pay the most for them and then subject to change, alienation and amendment through voluntary agreement.

Although Coase clearly favoured the greater use of market processes in the allocation of use rights to the spectrum he did not argue that regulation was totally unnecessary. He was discussing a starting position in which there was no scope for private agreements. Where large numbers of potential transactors were involved, however, and where the costs of transacting could be expected to be significant, the specification of rights by direct regulation would be preferred to reliance on decentralised bargaining. If, for example, some types of
equipment cause interference over a large area and over many frequencies ‘a regulation limiting the power of the equipment and requiring shielding would probably be desirable’ (p.30). Ultimately, rather like the boundary of the firm itself, the degree to which ‘rights should come about as a result of strict regulation and how far as a result of transactions in the market is a question that can be answered only on the basis of practical experience’ (p.34).

3.2 Public Utility Pricing

This research agenda of the patient study of practical organisational alternatives for handling problems of resource allocation became gradually more influential over Coase’s life. Coase himself studied the problems of public utility pricing – especially in the context of declining average costs. He was, for example, critical of the emerging literature in the 1940s that recommended marginal cost pricing (Coase (1946)). The theory of marginal cost pricing was and remains very persuasive for economists because it reflects the fundamental notion that the gains to trade will be maximised when the marginal benefit of a good (measured by marginal willingness to pay and therefore price) is just equal to its marginal cost. But, true to form, Coase was interested not merely in formal theorems but in the solution of practical organisational problems. In many regulated industries, higher output could be achieved at lower cost per unit. For cost per unit to be falling, the cost of additional units must be below the average. Pricing all units at the cost incurred at the margin would thus fail to cover total costs and the industry would face financial losses. The standard view associated with Hotelling (1938) and Lerner (1944) was that these losses should be covered from general taxation. Coase took the view that a two part tariff consisting of an overhead charge and a price per unit would be preferable since it would ensure that all costs were covered by consumers of the industry’s output.

His main points were that subsidies from the state would undermine managerial incentives to be technically efficient and impose hidden costs elsewhere in the economy where taxes would be required to raise the necessary revenue. Even an average cost price might be preferable to marginal cost pricing once all the possible difficulties of measuring marginal cost, controlling managers and imposing taxes were taken into account. With a single price on all units of output set equal to marginal cost there would be no ex-post check on whether consumers were prepared to cover the full costs of supply. ‘Nowhere’ comments Coase of Hotelling’s work, is there recognition ‘that it will be more difficult to discover whether to build new railroads or new industries if one does not know whether the creation of past railroads or industries was wise social policy’ (175-176). It is important to note here Coase’s scepticism of any government’s ability to know what people were prepared to pay for various outputs or what the opportunity costs of output are. In this he takes a view similar to Hayek (1945) on the information transmitted in prices that are generated through market processes. The prices (and the embedded information about consumers’ valuations and opportunity costs) emerge from market transacting and are most unlikely to emerge from governmental planning. Planning arrangements of all types (within firms as well as governments) rely to a large degree on the information produced across markets. There might be a ‘cost of using the price mechanism’ but there is also a cost of ignoring the price mechanism – deriving from the loss of information that would otherwise be revealed through its operation.
3.3 The Market and the State

One of the characteristics of Coase’s output is that his whole approach to economics made him very difficult to place in terms of ideology. Because he was writing in the mid to late twentieth century and (at first) in an intellectual environment highly supportive of planning and state intervention, his work has been seen as buttressing the claims of ‘markets’. It is clear that Coase did indeed see market transacting as of primary importance in terms of revealing information about consumers’ valuations and producers’ costs, as has been seen above from his paper on the Federal Communications Commission. On the other hand the foundational insight upon which his work was built that ‘it would seem to be that there is a cost of using the price mechanism’ is equally clearly a statement leading directly to the point that markets have their limits. Indeed it could be argued that Coase’s great contribution is to show that the market versus the State dichotomy is a misspecification of the organisational problem facing all communities. In a world of positive transactions cost the question is where in the great space between individual market transacting and full collective planning it is best to operate. The answer will differ according to the transactional hazards encountered in various contexts and will always be a matter of business judgment broadly defined.

Coase’s ‘market supporting’ credentials do not therefore derive from a position that market contracting is always best. They derive from his point that only the ability to try out different organisational settings and subject them to a test of survivability will reveal what structures are most productive. It is the existence of competition between alternative solutions to the problem of economising on the cost of transacting that is important. Planning and market transacting are both potentially helpful (indeed ideally equally so at the margin) and ‘what this mix should be we find as a result of competition’ (Coase (1992, 716)).

3.4 The Public Sector, Privatisation and Contracting Out

As the twentieth century advanced, Coasian policy problems were increasingly confronted as the domain of public production within state-owned firms diminished both in the ‘mixed economies’ of the West and in the formerly ‘planned economies’ of the East. At the most general level there was a worldwide substitution of contract for internal organisation. The old plan versus market debate mutated into a much more complex debate about institutional structures. Policy makers now had to consider whether public objectives might be better served by contracting with private suppliers rather than organising production within bureaucracies or state owned firms. Writers such as Shleifer (1998) concluded that only in cases where the quality of output was effectively non-contractible, where cost reducing innovations were very unlikely and where competition was necessarily limited, would government ownership be preferred to contract. The greater use of contract, however, implied that judgements about transactions cost became central to policy. In principle these decisions would be taken on the basis of careful appraisal of alternative available contractual settings as recommended by Coase. Public choice and other political pressures are, however, as capable of influencing judgements about contract as they are about decisions in nationalised or state-owned enterprises. In addition many contracts can involve very long periods of time, the disposition of large amounts of specific capital and very complex objectives. Such contracts
are very likely to require re-negotiation as time advances and the transactions costs incurred therefore can be very significant. Examples in the UK include Private Finance Initiative contracts to build and maintain schools and hospitals or provide accommodation for defence personnel. Public Private Partnership agreements have been used (with notable associated problems) to upgrade infrastructure such as the London Underground. The point is not that the use of contract is wrong but that the multifarious circumstances will often suggest differing contractual responses. Officials therefore were in the position of having to make judgements about contractual provisions under new conditions and when the Coasian research programme had hardly begun.

Related problems are faced in the field of utility regulation. The ‘New Paradigm’ of regulation encouraged across the world since the 1990s has recommended the vertical disintegration of privatised energy and transport utilities in order to permit competition to develop at those stages where it is feasible (Kessides 2005). This could be categorised as a Coasian policy in the sense that it enables a shift towards contract to take place from what would otherwise be very monopolistic and centralised structures, and (in principle) permits business experiment to occur at certain parts of the industry. More broadly, however, it is determining industrial structure by policy rather than letting it evolve as competing businesses gain experience of transactional and organisational costs. Where coordinating upstream and downstream activities by contract is relatively simple and is less costly than internal administration the model has obvious potential benefits. It simulates what a competitive process might be expected to produce anyway in an industry which did not face the ‘natural monopoly problem’ deriving from the use of a common network asset such as an electricity grid or a pipeline. Where transactions costs are large relative to internal organisation, however, and the industry would naturally tend towards vertical integration, the benefits of competition artificially supported at particular stages have to be compared with the higher costs of coordination between stages.

A transactions cost approach to the ‘New Paradigm’ suggests therefore that it is most unlikely that all regulated industries should be structured in the same way or indeed that a structure suitable for one country and set of legal institutions will be transferable to another. Transactions cost will itself depend upon many institutional factors - the reliability of the legal system, the degree of corruption, the public choice pressures, the technology available and so forth. A response to these problems in the UK that is organisationally efficient might not result in the same arrangements as in Nigeria. As Coase (1992, 718) emphasised, only more empirical work and the collection and analysis of data on the nature of contracts will permit a greater understanding of how ‘the structure of competitive industry’ evolves and how that understanding might in turn improve regulatory policy.

4. The Theoretical Legacy

4.1 The Nature of Transactions Cost

There is no doubt that Coase’s introduction of transactions cost into the economics literature has been hugely influential and provided a conceptual tool that has been useful in clarifying
theoretical issues (for example surrounding organisational structure) as well as suggesting ways of approaching whole new areas of enquiry (such as the economic approach to law). Conceptual tools are of great importance—for example the division of factors of production into land, labour and capital by the classical economists and the addition of ‘human capital’ in more modern times. They provide the essential building blocks of theory and determine the way we tend to look at things. The nature of the gains to trade became established fully by the end of the nineteenth century at the time of the ‘marginal revolution’. The importance of studying the cost of doing business and the wider institutional problems of actually capturing these gains was Coase’s great insight. Before his work the only well-established area in which transactions cost implicitly made an appearance was in the rationalisation of the use of money. Coase showed that the study of transactions cost reducing institutions could be taken much further and that we should not work on the false premise that the institution of money on its own reduces the costs of market transacting to zero.

Aspects of Coase’s original conception of the firm, however, have been modified and refined in more recent literature. Transactional relations remain central, but the firm is not simply an entity in which people are consciously organised and ‘directed’. Within the firm contractual relations can require more than the mere following of instructions and may encourage the exercise of a degree of judgement. Where close monitoring is costly and managers do not have access to local information the use of incentive contracts can be used or promotions and ‘tournament like’ structures implemented. Transactors in markets can find it hard to build trust where infrequent, complex and idiosyncratic agreements are required, and governance structures within firms have evolved to build this trust and enable transactions to take place that would otherwise be impossible. Firms might expand internationally or by the use of franchise arrangements to protect technical know-how or brand name capital. Here the firm substitutes for market transacting – just as Coase proposed – but the rejected costly transaction concerns the licensing of technology or the difficulty of transferring tacit knowledge to others by means of contract. Transactions cost has also featured prominently in explanations of the ownership of firms. Hansmann (1996) for example, argues that owners are those whose relationship with the firm is non-contractual. Owners possess residual control rights and tend to be the group (whether investors, consumers, suppliers or workers) who would otherwise face the highest cost of transacting with the firm.

The New Institutional Economics thus looks at contractual relations within firms as well as across markets. The clear Coasian distinction between the firm as a mini planning mechanism and the unconscious cooperation of the competitive market begins to look less clear cut. Both firms and markets require governance, and the method by which this governance is established (by evolved convention, by the private action of owners or by collective action – through local and voluntary associations or at the State level) is a major subject for study. The research agenda integrates the subject matter of ‘the nature of the firm’ and ‘the problem of social cost’. The overarching theme is the study of the ways that people overcome transactional impediments and achieve the potential gains from agreement whether these are within organisations such as firms, through local traditional collective institutions or through more centralised state intervention. In other words a Coasian light can be shone not
merely on private contract but on the development of voluntary associations and even on Public Choice.

Transactions cost as a conceptual tool has proved to be a powerful device. It remains to be seen, however, how far it can be deployed as a tool of practical policy. Just as prices in neoclassical theory are supposed to reveal marginal costs and marginal benefits, observed institutions and organisational arrangements under competitive conditions might be used to reveal transactions costs. Observe a surprisingly disintegrated structure (as, for example, the Swiss watch making industry in the early twentieth century) and we deduce that transactions cost must have been relatively low for some reason. This can be enlightening. But to use observed prices or institutional structures to infer marginal costs is one thing. To use marginal costs to recommend prices or institutional arrangements is quite another. Without prices, as the Austrian economists were at pains to point out, no one could work out what marginal costs were. Managers in nationalised industries could make a case for almost anything. In a similar way, the calculation of transactions cost in any given set of circumstances is likely to prove very problematic. The regulatory implications of transactions cost economics are not therefore that ideal arrangements can be imposed but rather that the scope for trial and error discovery should be protected and not closed off. Transactions cost might be difficult to measure, but ensuring that the ‘impediments to private agreements’ are reduced rather than increased, as required by the ‘normative Coase Theorem’, is arguably a somewhat less demanding task. This approach to policy can be seen in Coase’s interpretation of ‘big bang’ versus marginalist approaches to reform in developing and transition economies.

4.2 Coase’s Approach to Economics

Coase did not engage in fruitless methodological controversy. His work used conventional terminology and was, to a degree, ‘conservative’ of the established tradition. Nevertheless it did highlight the limitations of static neoclassical analysis. Organisational problems and contractual responses derive ultimately from imperfect information and the uncertainty that inevitably accompanies the passage of time. A world of perfect (zero cost) information would be a determinate one – the future mapped out and encapsulated in a set of agreements covering all future time periods. In fact, institutions such as money or the firm emerge as a way of coping with the fact that we do not inhabit such a world. They enable us to keep our options open and to respond to emerging events. Coase (1937, 391) himself wrote of the cost not only of negotiating contracts but of re-negotiating them to take account of changing circumstances and ‘the difficulty of forecasting’ or exactly specifying what another party is to do over an extended time period. The response to these contractual costs was ‘the firm’ - a set of loosely specified contracts of employment with a central agent with the flexibility to alter (within limits) the employees’ activities over time.

His overall conception of economic life therefore was not one of static equilibrium but of a complex evolving system. In this he stood in the tradition of Alfred Marshall who argued that economics had affinities with the study of biology. The influence of these ideas can be seen in Coase and Wang (2012) which looks at the economic history of China since the death of
Mao. One of their major conclusions is that there was no clear policy decision at the highest level to embrace market processes. ‘When China began reform in the late 1970s and early 1980s, it was a series of marginal revolutions that introduced the private sector and market forces, which overshadowed the state-led reform initiatives and gave the reform a strong orientation towards the market’ (p.109). Coase and Wang criticise those who considered gradual transition impossible and who therefore recommended a ‘big bang’ approach to reform as succumbing to Hayek’s ‘fatal conceit’ of constructivist rationalism. A transition to a market economy cannot be imposed in a master plan. If such a thing were possible it would have been relatively easy to plan the economy in the first place. ‘China was fortunate to escape from this fatal conceit only by accident’ (p.155).

This interpretation of recent Chinese development thus draws attention to the way that quite basic reforms – such as the establishment of private property in certain limited but important areas – could have powerful consequences and lead to a cumulative growth of trust, imitation and further institutional innovation. From a transactions cost perspective the limited introduction of property rights permitted deals to be struck that had not been possible before. These market deals revealed information about the valuations of consumers and producers and produced large gains to trade. This in turn encouraged imitation, pressure for further reform and experiment with new organisational structures in a cumulative process.

5. Conclusion

The work of Ronald Coase represents a profound and consistent critique of mainstream economics. It stimulated the development of whole new sub-disciplines and also enabled intellectual links to be established with other social sciences such as Politics and Law. This pervasive influence is reflected in the fact that it is possible to describe a writer as ‘Coasian’ with the expectation of being understood, and it reflects the fundamental importance of the concept of transactions cost to a discipline which, he reminded us, is fundamentally about exchange and the social institutions that facilitate it.

These institutions interact with one another in a complex and evolving ecology. Coase accepted that the contractual setting of a particular firm would ideally need to be studied in conjunction with its contractual relations with other firms as well as the general legal, social, cultural and technological background. He admitted that this led to ‘a complicated set of interrelationships the nature of which will take much dedicated work over a long period to discover’ (Coase 1998, 73). But he was optimistic that the study of contracting in a ‘real world setting’ would lead to greatly improved understanding of the ways that institutions affect transactions cost and thereby help or hinder economic performance. It is doubtful, however, whether the Coasian research agenda can ultimately be made compatible with received ‘standard’ theory. Like evolutionary biology and Newtonian physics they would seem to require different research methods and to imply different prior assumptions about the nature of the system under investigation.

References


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i For introductions to this literature see Kasper and Streit (1998) and Furubotn and Richter (1997).

ii Spinning tended to be located in the South of Lancashire and weaving in the North.


v The proposition that rights should be structured so as to minimise the impediments to private agreements is referred to in the modern literature as the ‘Normative Coase Theorem’ – see Cooter and Ulen (1997).

vi Sturges v. Bridgman (1879)

vii Cooke v. Forbes (1867)

viii Bryant v. Lefever (1878)

ix Vaughan v. Taff Vale Railway Co (1860)

x Coase (1992) in his Nobel lecture attributes the naming and formulation of this ‘theorem’ to George Stigler. Coase’s (1960) version is as follows: “The ultimate result (which maximises the value of production) is independent of the legal position if the pricing system is assumed to work without cost’. Because a different assignment of initial rights implies a different distribution of income between transactors there will (except in very special circumstances) be ‘income effects’ that influence the range of final agreements achievable and hence the final outcome. It remains the case, however, that the transactors will bargain to a position which exhausts all gains to trade.

xi See, for example, Lazear (1995).

xii As described in Williamson (1979).

xiii See, for example, Kasper and Streit (1998).

xiv Ostrom (2005) (2012), for example, is noted for studying the diverse ways in which communities have responded to the problem of common-pool resources.